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SUBJECT: UK SPECIAL LIQUIDITY FACILITY IS A SUCCESS

Summary

¶1. (U) By ensuring broad participation, including the UK's five largest banks, and by ensuring strict confidentiality, the Bank of England's (BOE's) Special Liquidity Facility (SLF) has eliminated the stigma associated with borrowing from the BOE. Because of this, BOE contacts told Econoff that the SLF announced April 21, 2008 is a success. The multi-year SLF facility was developed to inject liquidity into the banking sector by swapping illiquid assets for liquid ones. The BOE is not required to disclose such swaps so that even aggregate bank usage remains strictly confidential. There is no limit on the size of the facility, but estimates range from GBP 50 billion to more than GBP 90 billion. Swaps will remain outstanding for three years, but must be entered before October 21, 2008 when the facility expires. Multi-year maturity is intended to dampen recent financial market volatility. The BOE says it will disclose the aggregate value of swaps outstanding after the SLF expires on October 21. BOE Governor Mervyn King has said the BOE will announce a new lending facility by year end 2008. Because of the success of the SLF in dealing with the stigma issue, the new facility is likely also to utilize asset swaps and will likely permit shorter-term borrowings and be ongoing with no fixed expiration. END SUMMARY

Mechanics Of The SLF

¶2. (U) The BOE announced the SLF on April 21, 2008. On June 17, Econoff met with Sarah Breeden (protect), Head of the BOE's Risk Management Division and Sarah John (protect), Manager Operations Development at the BOE to discuss the SLF. It will be available for six months, expiring on October 21, 2008. All banks and building societies with assets greater than GBP 500 million are able to participate in the SLF, but participation is voluntary. All aggregate details of the SLF as well as details of each bank's participation are strictly confidential. However, the BOE will disclose the aggregate value of swaps outstanding at the time the SLF expires on October 21 and annually thereafter until the last swaps are settled by October 21, 2011. Industry estimates SLF borrowing is in the range of GBP 50 billion to over GBP 90 billion. Participation requires that an institution achieve a minimum level of borrowings within a specified time. The minimum level is related to the size of the institution. Elements of the facility include:

-Prepayment is permitted but only down to the specified minimum level.
-There is broad participation, including the top five UK banks.
-There is no cap on the value of swaps the BOE will enter as part of the SLF.
-Swapped assets must be AAA rated and all credit and default risk remains with the participating bank.
-The maturity of each swap is one year, automatically renewable twice for one year for a final maturity of three years, after which the swap is unwound. Breeden said the three-year maturity was chosen specifically to provide longer term liquidity and stability at a time of high volatility in the financial markets.

-Swapped assets must have been on the bank's balance sheet on December 31, 2007.
-The per annum cost of using the facility is based on the spread between the three-month LIBOR rate and the repo-rate for government collateral (currently 75 basis points). The fee is re-set quarterly.

Valuation

¶3. (U) The value of government bonds for which a bank can swap illiquid assets depends on the value of the assets as determined by the BOE and the discount (haircut) attributable to the type of asset being swapped.

-Valuation: The BOE relies on market prices where they are available or in-house risk-adjusted discounted cash flow modeling. The BOE relies solely on its own valuation of swap assets, even though a bank may have used similar modeling techniques to value its illiquid securities.

-Discounts (haircuts): The value of government bonds available in a swap is determined by discounting the value of a bank's swap assets by from 12 to 22 percent. The minimum discount of 12 percent applies to securities that neither were created by the swapping bank by bundling individual mortgage assets (called own name securities) nor require BOE modeling to determine value. Own name securities and securities that must be modeled each incur an additional 5 percent discount for a maximum discount of 22 percent.

Dealing With The Stigma Issue

¶4. (SBU) Although the BOE has long been available as a lender of last resort, the UK financial markets have punished the share prices of banks that approach the BOE for assistance. A request is taken as a sign that a bank is in serious financial difficulty. Accordingly, banks have been reluctant to utilize the BOE as a funding source. Breeden said it took over four months to develop the SLF and much attention was paid to avoiding the stigma associated with borrowing from the BOE. The BOE chose to use asset swaps because there is no requirement to disclose even aggregate data on the number and size of swaps. The BOE hoped that non-disclosure by the BOE combined with strict confidentiality agreements with participating banks would eliminate the stigma issue. While the SLF is still new, Breeden said that this key objective of the SLF has been achieved. As a result, she said the BOE considers the SLF a success.

Lessons Learned

¶5. (SBU) BOE Governor Mervyn King has announced that a liquidity facility is being developed to succeed the current SLF facility. Breeden said the new facility will be announced before the end of the year. It will likely include the use of swaps due to the success of this mechanism in the SLF. However, she said the new facility may not mandate multi-year borrowings. The three-year maturity of draw-downs under the SLF was selected in an attempt to reduce short term volatility in the financial markets. The new facility will likely facilitate shorter term borrowing to be used in the ongoing ordinary course of business. Consistent with this objective, the new facility is being developed to be an ongoing facility with no expiration.

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